Statement of

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Hearing on

"The Long and Short of Hedge Funds: Effects of Strategies for Managing Market Risk"

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Chairman Baker, Ranking Member Kanjorski and members of the committee. I thank you for allowing me to share some thoughts on the important matter of who should be allowed to invest in hedge funds.

My name is John Mauldin. I am the president of Millennium Wave Investments, an investment advisory firm. I have been involved in the alternative investment world since 1989. I frequently speak on a wide variety of topics at hedge fund and institutional investor conferences. I write a free weekly e-letter which goes to over 2,000,000 readers on investing and global economic issues. A more complete bio is at the end of this statement.

It is my contention that the positive values that hedge funds offer to rich investors should also be offered to the middle class, within a proper regulatory structure. The current two class structure limits the investment choices of average Americans and makes the pursuit of affordable retirement more difficult than it should be. The rich have a considerable advantage in growing assets for retirement in that they simply have more assets to begin with. They should not also have an advantage in better investment choices.

Specifically, I will address the questions of: why should 95% of Americans, simply because they have less than $1,000,000, be precluded from the same choices as the rich? Why do we assume those with less than $1,000,000 to be sophisticated enough to understand the risks in stocks (which have lost trillions of investor dollars), stock options (the vast majority of which expire worthless), futures (where 95 % of retail investors lose money), mutual funds (80% of which underperform the market) and a whole host of very high risk investments, yet are deemed to be incapable of understanding the risks in hedge funds?

Let me briefly describe how we have come to the current situation. I will compare some of the investment opportunities, like mutual funds, to which average investors have access, with the performance of hedge funds available to the wealthy. We will look at the risks involved in hedge fund (and all) investments, and then suggest some ways in which the regulation of funds could be expanded to offer more choices.

First, let me point out that the current state of the hedge fund industry is the result of laws that were written in the 1930s and 40s, long before anyone ever thought of a hedge fund. The path that we have come down is not one of deliberate forethought, but a response on the part of entrepreneurial investment managers to improve investment returns for clients within the current regulatory framework. A quick history will illustrate this.

The first hedge fund was formed by Alfred Jones in 1952. He had the novel idea that by having a fund which could be long stocks he thought would go up in value and short stocks he thought relatively over-valued, that he could produce better risk adjusted returns for his clients. He also decided to keep a percentage of the profits he made for his clients. Due to limitations imposed by Federal securities laws, the only available legal vehicle for him at that time was a private limited partnership. Thus he was forced to not advertise or publicly solicit investors. This became the pattern from which future hedge funds were cut.

As Fortune noted in 1966, his performance was better than that of any mutual fund.[1] This article, as a Fortune article in 1970 noted, created "almost overnight a raft of would-be hedge fund managers, most of whom were convinced that Jones had discovered the millennium." [2]

It also created the first calls for regulation. Again quoting, "…certain members of the SEC staff have already concluded that the Commission must take steps to regulate these funds… One staff member spoke recently of the 'crisis numbers' to which the funds have grown, and there has been much SEC talk about the 'impact' of the funds on the market."[3] Fortune estimated there were some 150 hedge funds by 1969.

As an aside, the article noted that investors were subject to strict suitability requirements. Thus, women were the most often persons rejected as investors. Remember, this was 1969. I would highly recommend this article as historical must-reading for all who are charged with the regulatory process involving hedge funds.

While we use the term "fund" when talking of hedge funds, I find it more helpful to think of individual hedge funds as businesses. The growth of the hedge fund industry since 1966 has been the result of investment entrepreneurs deciding, rightly or wrongly, that a particular investment strategy offered a certain type of return which would be attractive to some investors. Like any new business, if they satisfied their customers they prospered and grew. If they did not meet expectations, they went out of business.

The early hedge funds had a fairly limited range of strategies. As time wore on, different pioneers thought of new ways to earn absolute returns instead of the relative returns of the market. By absolute returns I mean actual profits at the end of the day. Investors in hedge funds do not want to hear the song of relative returns: "We are a good fund. The market is down 30% and you are only down 25%."

Today, there are dozens of different categories of hedge funds, with all types of objectives. Depending upon which information source you choose, estimates now range between 5,000 and 6,000 hedge funds

This growth has partially come about because of the availability of technology and a wide array of new investment opportunities. Stock index futures and interest rate futures were not introduced until the early 80's. Hedging interest rates and currency risks was very difficult as recently as the 70's. Today, it is done by many businesses as a routine matter. A reported 80% of the convertible bonds sold by US businesses to finance

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[1] "The Jones Nobody Keeps Up With" Personal Investing, Fortune, April 1966.
[2] Loomis, Carol, 1970. "Hard Times Come to the Hedge Funds, " Fortune. January.
[3] Ibid.

their investments in the economy are sold to hedge funds. A whole host of derivative products have been created to help investors hedge certain types of risk.

But the most significant reason for the growth of the hedge fund industry is investment returns. Simply put, if high net worth investors and institutions could get the same returns as hedge funds by simply investing in stocks, bonds or mutual funds, why would they choose hedge funds which have higher fees, are hard to find and evaluate, and need more scrutiny? The answer is they would not. The demonstrably observable higher risk-adjusted returns make the effort worth it.

The key to this is the word “risk-adjusted.” Hedge fund investors are not necessarily looking for higher returns. They are looking for strategies that can give them reasonable returns for the risks involved, or looking to lower the risks while getting potential steadier absolute returns.

We will now look at four types of mutual funds available to the average investor and the related performance of their hedge fund counterparts. We will look at US stocks, US bonds, international stocks and a specialty niche within both mutual funds and hedge funds called convertible bonds, which will give you some idea what hedging can do to the risks and returns for investors.

Before we look at the numbers, please understand that hedge funds are not investment nirvana. Investors can and do lose money. The data I show demonstrate that hedge funds do not always make money, even for longer periods of time. I am not contending that there are not substantial risks involved in investing in hedge funds. It is clear to anyone in the industry that there are.

My contention is that the risks are simply different than the substantial and generally known risks in normal stock and bond investing. It is not a matter of risk or no risk, it is more a matter of what type of risks would a prudent investor choose as appropriate for his portfolio. The availability of that choice should not be based upon the wealth of the investor but on his experience and competence. Wealth does not automatically confer superior investing skill and judgment.

Further, I would suggest it is no more difficult to understand the large majority of hedge fund strategies than it is to understand the business plan and risks of an investment in Cisco or other related technology company. Does anyone here believe that 99% of the investors in Cisco understand what a router does, whether China poses a threat to their business model and what their competition is likely to do?

Investors in Cisco have lost hundreds of billions of dollars. All told we have seen the evaporation of trillions of dollars from investors in the US stock market, yet no one suggests investors should not be allowed to invest in stock. Schwab recently reported that 40% of their clients did not realize that they could lose money in ordinary bonds. When interest rates begin to rise and bond investors lose money, will anyone suggest that investors not be allowed to invest in bonds because they do not understand the risks?

Critics of hedge funds typically cite that they are illiquid, highly leveraged, subject to a variety of uncertain market risks, subject to fraud, and the returns are highly volatile. I would readily agree with all those statements. But I have also just described the home real estate market. Additionally, homes are subject to termites, tornadoes, hurricanes and floods. Those of us who live in Texas know that home values can go down as well as up. Yet no one would propose that the average US citizen is not capable or smart enough to ascertain the risks of home ownership.

That being said, hedge funds pose different types of risks than homes, mutual funds and/or stocks. These are risks with which investors are unfamiliar, and thus to let investors into hedge funds without ample time to understand this new set of risks is not appropriate.

Let me briefly note that no essay on hedge funds should fail to mention Long Term Capital Management, along with the relatively few other large hedge fund failures. I would point out that Long Term Capital failed for precisely the same reason that the mutual fund Janus Twenty lost over ten billion dollars of investor's net worth: they had very well-known managers who built up highly concentrated positions which were very difficult to exit. Long Term Capital lost a few billion of investor money, much of which was the investment of the fund management.

Yes, there have been some outright frauds in the hedge fund world. They pale in size by comparison with the frauds committed by regulated public companies, perhaps a fraction of 1%. The established hedge fund investment community has a pretty good record of not investing in outright frauds.

I have provided in Appendix Three a brief essay on the risks in hedge funds and the due diligence process.

In Appendix One, I provide a series of charts and tables comparing certain mutual funds and indexes with their corresponding hedge fund counterpart. Let me briefly present a summary.

First, let's look at how hedge funds have done vis-à-vis the stock market and certain mutual funds. There are many different hedge fund strategies which are basically stock market strategies. I will use one of the more well-known hedge fund strategies: equity market neutral as represented by the CSFB/Tremont index. This style of long-short equity fund tries to eliminate the fluctuations of the market by precisely balancing long and short positions in stocks to avoid any market directional speculation. In Appendix Two I provide some notes on Market Neutral Investing

(There are indexes and hedge fund investment styles with better returns and with poorer returns, so it is possible to create either more or less favorable comparisons. But I believe this hedge fund investment technique or style is typical and representative. An exhaustive comparison could take hundreds of pages, but would, in my opinion, produce the same overall impression.)

Equity Mutual Funds vs. Hedge Funds

First, let's compare the market neutral index with the S&P 500 (dividends included), as many investors use an S&P 500 index mutual fund as their proxy for the market.

Fund	Volatility	1 Year	3 Year	5 year	10 year
Equity Market Neutral (CSFB HedgeIndex)	3.14%	5.85%	8.06%	10.39%	10.69%
S&P 500	16.34%	-15.17%	-14.59%	-3.47%	7.75%

The typical S&P index fund had volatility[4] as measured by standard deviation of over five times the market neutral index. High net worth investors have watched their returns drop in the last few years, but are still comfortably in the black with this strategy. I am at a loss as to a reason for why investors should not be allowed to invest in such a fund strategy.

Let's compare hedge funds to one of the largest and most popular of mutual funds (name available upon request).

Fund	Volatility	1 Year	3 Year	5 year	10 year
Equity Market Neutral (CSFB HedgeIndex)	3.14%	5.85%	8.06%	10.39%	10.69%
Sample Large Popular mutual fund	17.13%	-14.26%	-14.13%	-2.10%	7.52%

(Volatility is based on monthly returns over 9 years annualized.)

Investors were well served by this fund during the bull market of 1982-2000. This fund seriously out-performed not only this index, but most hedge fund indexes in the recent bull market, rising 598 % from March of 1990 until March of 2000. Since that time, they have seen their assets lose over 42%. The annual volatility of this fund was over five times that of the average market neutral fund.

The management of this fund is some of the best available anywhere. However, they are limited to a long only strategy. You live by the bull and die by the bear.

Let's now look at one of the largest and most popular of technology funds, which invested in a highly concentrated portfolio of technology stocks (name available upon request). Management for the fund told investors it was their stock analysis which

[4] Volatility here is defined as standard deviation. Standard deviation quantifies the dispersion or scattering of returns around the average return for a given period. The higher the standard deviation, the more volatile the investment. Hedge fund investors typically seek lower standard deviations and steady performance. For this statement we use monthly returns over the entire period to produce an annual volatility.

enabled them to give investors very high returns. This fund was up 679% from March of 1990 until March of 2000. Since then, it has dropped 67%, cutting its return by two-thirds and costing average investors over ten billion dollars of net worth. Volatility was almost 8 times that of the market neutral index. This fund is by no means the worst performing technology fund. At its peak, it had over $25 billion, much of it from small investors. Which fund would they choose today if they had access to the market neutral funds available to the rich?

Fund	Volatility	1 Year	3 Year	5 year	10 year
Equity Market Neutral (CSFB HedgeIndex)	3.14%	5.85%	8.06%	10.39%	10.69%
Sample Technology Fund	24.98%	-8.05%	-27.63%	-3.96%	3.46%

Finally, let's look at the entire range of equity mutual funds[5] vs. the entire range of hedge funds. We asked Morningstar to give us an index of all equity mutual funds, and took the Tremont index of all hedge funds.

Fund	Volatility	1 Year	3 Year	5 year	10 year
CSFB/Tremont Hedge Fund Index	8.79%	4.98%	6.02%	5.84%	11.27%
Morningstar US Div Return	5.69%	-7.39%	-4.50%	-0.81%	1.03%

Let me again emphasize that hedge funds are not investment nirvana. Some hedge funds are very volatile and extremely risky, as are some mutual funds and stocks and futures. Some hedge funds are fairly stable and boring, as are bonds. Lumping all hedge funds styles into the same category can be very misleading. Simply because a person is a member of congress does not mean they are the same.

But just as voters get to choose the type of congressional representative they want, so too should investors be able to choose the type of funds and risk they or their advisors feel appropriate

Convertible Bonds

A popular hedge fund style because of its potential for steady returns is convertible arbitrage. A convertible bond is sold by a business. It pays an interest rate and is convertible into common stock at a specific price, usually much higher than the stock price at the time when the bond is sold. If the stock rises in price, the convertible bond becomes more valuable. However, it still pays interest until the time of its conversion. Thus it has the characteristics of both a stock and a bond.

[5] This is an average of all US diversified equity funds that fit with in the 9 Morningstar style boxes, which include growth, value, blend, small cap, mid cap and large cap. It excludes any hybrid funds that include bonds and sector funds.

A convertible bond arbitrage fund attempts to hedge out the risk of the stock portion of the bond by shorting the stock. They also typically use leverage to increase the returns. The leverage used varies widely from fund to fund.

Morningstar has an index of mutual funds which invest in convertible bonds. This is the typical return an average investor would have received from a long only strategy.

Notice what happens when appropriate hedging techniques are used. Returns are tripled over the last 5 years and volatility is halved. Why do we assume investors can understand the risks of investing in IBM and cannot understand this rather straight-forward process? Why should the average investor be denied access to this investment strategy if they want to invest in convertible bonds?

Fund	Volatility	1 Year	3 Year	5 year	10 year
CSFB HedgeIndex Convertible Arbitrage	4.84%	11.35%	10.81%	10.34%	10.93%
Morningstar Convertible Bonds	11.68%	-0.83%	-2.87%	3.32%	8.16%

Emerging Markets

In one of the most volatile and difficult markets anywhere, that of investing in stocks and bonds of emerging market countries, hedge funds have demonstrated a steady, if not spectacular, series of gains for their investors. For those investors who believe it wise to diversify into international stocks, which group of funds would the average investor prefer to have available?

Fund	Volatility	1 Year	3 Year	5 year	10 year
CSFB HedgeIndex Emerging Markets	18.27%	3.64%	5.80%	2.66%	6.00%
Morningstar Diversified Emerging Markets	23.48%	-15.11%	-9.85%	-2.41%	-1.44%

Government Backed Mortgage Bonds (Ginnie Mae's, etc)

Let's take the most prosaic and basic of investments: the Ginnie Mae bond. Again, hedge funds have outperformed their mutual fund counterparts. But that does not tell the whole story.

Fund	Volatility	1 Year	3 Year	5 year
CISDM Mortgage Backed Index	2.28%	8.29%	10.79%	9.78%
Morningstar Government Mortgage Index	3.08%	7.27%	7.87%	5.97%

Hedge funds have achieved their gains by hedging out the interest rate directional risks and use leverage to increase the returns. Mutual funds have achieved their gains by benefiting from the lowering of rates which causes the value of their bonds to rise.

What will happen when the economy recovers and interest rates start to rise? A rapid rise of 2% on a 30 year mortgage bond that sells for 5.3% today would cause the value of the bond to drop 24.21%. Even a slow change could cause values to drop by 10-15%. That will cause the funds to lose money. Investors who thought they had a conservative government backed bond fund will find themselves with no returns.

Which is the better and more conservative approach to investing in Ginnie Mae bonds? Do you want to take the risk of rising rates or do you want the risk of leverage?[6]

The Hedge Fund Investment Company

Let me suggest the following: the creation of a new type of investment company vehicle. Simply modifying the current mutual fund rules might work, but it is not direct enough, in my opinion. Let's call this new vehicle a Hedge Fund Investment Company or HFIC. Let me describe it first and then outline some of the advantages.

A hedge fund would be allowed to register with the SEC or CFTC as an HFIC. They would be required to have an annual independent audit, at least quarterly independent valuations of their assets and independent administrators, plus they would be subject to SEC or CFTC advertising rules. There would be few, if any, limits on the strategy the fund could employ, and they could charge a management fee and an incentive fee. They would have to fully disclose not only the relevant risks, but full disclosure of information on their strategies, personnel and management experience.

As with mutual funds, there would be no limits on the number of investors. They would be allowed to advertise within current regulatory guidelines. With certain restrictions outlined later, they would be able to take non-accredited, or average, investors.

As noted above, hedge funds pose a set of different and unfamiliar risks than do stocks, bonds or mutual funds, not to mention futures, options and real estate, all of which are available to the average investor today. I would suggest that for a certain period of time, say 7-10 years, an HFIC be limited to investors who can demonstrate a required level of investment sophistication or to investors who use an investment advisor or broker who has passed an appropriate exam demonstrating competency in hedge funds (such as the Chartered Alternative Investment Analyst program sponsored by the Alternative Investment Management Association) or a sufficient number of years experience in the industry.

After the end of the period for investors to come to some understanding of what an HFIC is, as well as develop sufficient track records, these funds would then be available on an equal basis with mutual funds, stocks, bonds, futures, real estate, options and a host of other risky investments currently available to the average investor. This time period would also allow for a support industry and independent analysis firms to develop.

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[6] There are other and quite serious risks of investing in Ginnie Mae bonds and hedge funds. I do not want to suggest these are the only risks.

The simple fact is that most institutional funds hire outside analysts to evaluate and recommend hedge funds. They also hire consultants and outside managers to recommend stocks and bonds. The actual individuals sitting on institutional and pension boards do not make the initial investments decisions, although the final authority is in their hands. I would suggest for your consideration that many of the people on these boards are not accredited investors. Yet they are considered capable of evaluating the appropriateness of whether or not to invest in hedge funds. The evidence is that increasingly large numbers of them are doing so.

They are no different than the individual smaller investor. If you create a situation where they can access appropriate sophisticated advisors, they will do so. Indeed, they do so now. There are tens of thousands of advisors and brokers who offer investment services to the public. They simply do not have hedge funds as a choice.

Would hedge funds willingly register? My belief is that they will. Because of my involvement in the hedge fund industry. To say that there are thousands of funds who are seeking money is not an exaggeration. The problem today is that they must do so privately and only to high net worth investors and institutions.

If they could approach a new class of investor I believe that many of them would do so. The current rules do not allow them to do so, and so they do not. It is not the desire of the industry to be secretive. It is the requirements of the law. Hedge fund managers certainly have no personal bias against small investors. The reason hedge funds avoid small investors is primarily legal. The large majority of managers simply want an appropriate amount of money to manage. If the rules allowed for appropriate and knowledgeable investing by smaller investors, they would adjust their programs to accept such.

A few comments on what might happen in the real world if such an investment vehicle as the suggested HIFC came about.

The likelihood is that a large majority of the initial HIFC funds would be existing fund of hedge funds. Many of these have long established track records and are well diversified. The process of taking numerous smaller investors would be no more problematic for a fund of funds than for a mutual fund. Certainly those funds of hedge funds who are registering under the currently available system anticipate taking many investors.

Secondly, I think it is likely to drive down fees over time. Just as the outrageously high fees of commodity funds came down in the 90's as more funds became available, and many mutual funds are available with quite low fees, I think you would see an investor friendly fee structure develop, especially for funds which are similar in nature.

The advantage of developing a new fund structure is that it does not displace the current status quo. If a fund wishes to remain private, they can do so. If they wish to go through the hoops of registering, that avenue would be available.

The reality is that the above disclosures I suggest are no more than what they already do today. If I or similar professionals cannot get the information we need to evaluate a manager, we simply do not invest. “Black Box” investing is an invitation for serious problems. Thus, as time went on, managers with good programs and steady risk-adjusted returns would realize that an HFIC requires no more than their current high net worth clients are requiring on a private basis today. The HFIC would simply be seen as another way for raising funds.

Finally, funds should have the choice of whether to be regulated by the CFTC or the SEC. The CFTC currently regulates 55 out of the 100 largest hedge funds since they are registered as commodity pools. Patrick McCarty, General Counsel for the CFTC noted at the SEC Hedge Fund Roundtable last week that out of the 2400 funds registered with them, they had only 10 complaints last year. If an HFIC uses futures, then they should be allowed the choice of which regulatory authority to choose, but not be subject to duplicative process which force extra expense.

The good news for investors is that over time they would be able to access these funds now only available to the rich. I should point out, that even though the rules say an Accredited Investor is someone with $1,000,000 or more, that does not mean that on a practical or legal basis they can access the large majority of hedge funds. On a practical basis, a net worth of $5,000,000 or more is required before you can begin to avail yourself of many of the better managers, and the top funds which have high minimums often have a much higher practical requirement for net worth.

This new industry would grow slowly, as did mutual funds when they were first offered. Over several decades, I would suggest that they would become standard fair for investors. They would not replace mutual funds or other investments. They would simply be one more choice, just as they are now for the rich.

In summary, let me say that we should evaluate the decision whether or not to allow smaller investors the same rights as larger investors in the light of three questions:

1. Is it appropriate?

The premise of Modern Portfolio Theory is that you can increase the returns and decrease the risk of an investment portfolio by adding non-correlated investment asset classes, even if those individual classes are individually highly volatile. Many hedge funds styles, by any reasonable assessment, are highly uncorrelated with the stock and bond markets. High net worth individuals and institutions are taking advantage of this fact by diversifying a part of their portfolio into hedge funds. This reasonable diversification should be made available to smaller investors as well.

No one would suggest that all or even a significant proportion of an investor’s portfolio should be in hedge funds. But a reasonable diversification is appropriate.

There is no real reason to believe that smaller investors cannot understand hedge fund strategies if properly explained. If investors can be assumed to understand the risks involved with individual US stocks, foreign stocks, commodity futures, currencies, options, mutual funds and real estate, not to mention a host of Reg D limited partnerships, then how can anyone suggest that hedge fund strategies are beyond the ken of investors?

I would suggest that investors can understand quite readily the logic and value of hedging the interest rate directional risk from a bond fund, or pairing under-valued and over-valued stocks, or hedging a convertible bond. While management competence is the real issue investors should focus on, how difficult is it to understand the concept behind buying under-valued assets in a distressed debt fund?

A hedge fund is a business, generally with a straight-forward premise. It is no more, and often far less, difficult to understand than the business risks and plans of typical US based company, to say nothing if a bio-tech or high tech firm or international company than the risks and concepts of a typical hedge fund.

2. Is it the right thing to do?

Most hedge funds have an offshore version with lower minimums. The reality is that investors from Botswana have more and better investment choices than do US citizens from Baton Rouge, Louisiana.

If you ask the brokers and investment advisors on the front lines of serving the public whether they wish they had access to hedge funds on behalf of their clients during this last three years, the answer would be a large yes. If you ask investors whether they should be able to make their own decisions – to have the same choices as the rich - the answer would also be yes.

The only people who benefit from limiting investor choice are those who have a vested interest in not facing the competition from hedge funds. As they seek to protect their turf, they have lost sight of the interests of those whom they should be serving.

Those who oppose allowing average investors to have the same choices as the rich must tell us why smaller net worth investors are less intelligent or are deserving of less options than the rich. They should show why average investors should only be allowed funds which are one way bets on an uncertain future.

I believe that investors would tell you that not allowing them the same choices as the rich is the type of government protection that they do not need.

3. Is it fair and just?

With all the proper regulatory scrutiny being devoted to hedge funds, with the concern of hedge funds that such activities could restrict their investment options and business, it would behoove us to remember the small investor, who is not even allowed a hedge fund crumb from the rich man's table. The focus of future regulation should be to make sure there is an honest game on an even playing field, not to exclude certain classes of citizens.

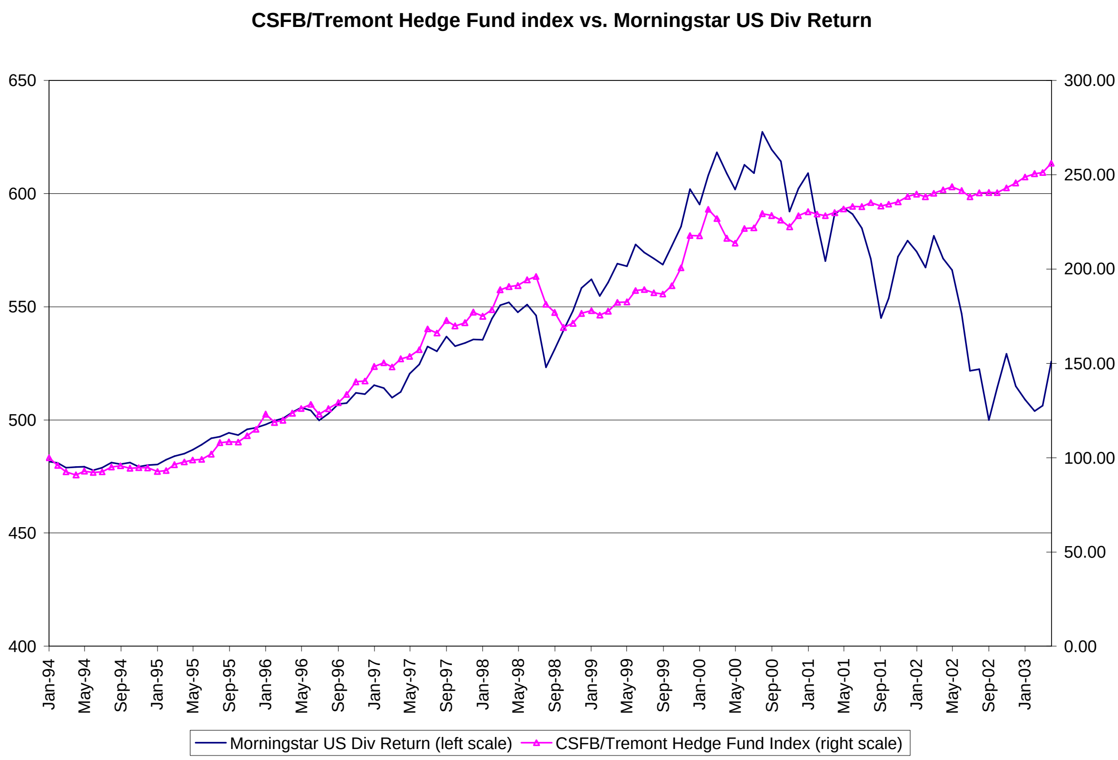
To put it simply: it is a matter of Choice. It is a matter of Equal Access. It is a matter of Equal Opportunity.

I believe it is time to change a system where 95% of Americans are relegated to second class status based solely upon their income and wealth, and not on their abilities. It is simply wrong to deny a person equal opportunity and access to what many feel are the best managers in the world based upon old rules designed for a different time and different purpose. I hope that someday this committee will see to it that the small investor is invited to sit at the table as equals with the rich.

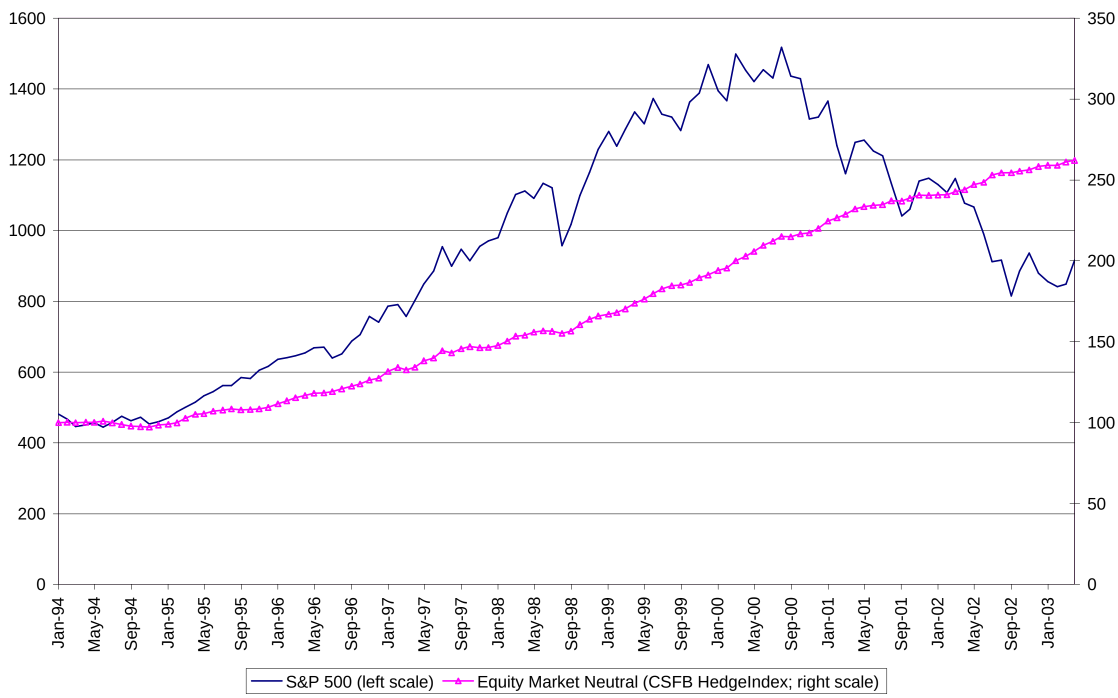
Mr. Chairman and members of the committee, thank you for your time and indulgence.

Appendix One

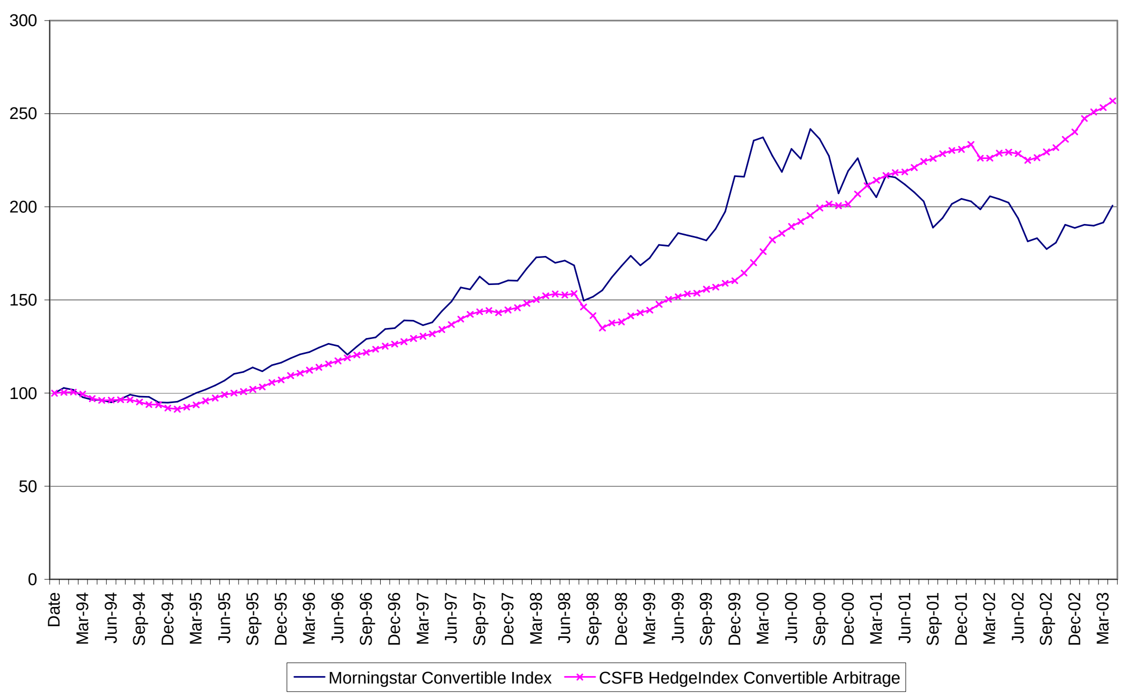
The following are charts of the tables presented on pages 5 through 8



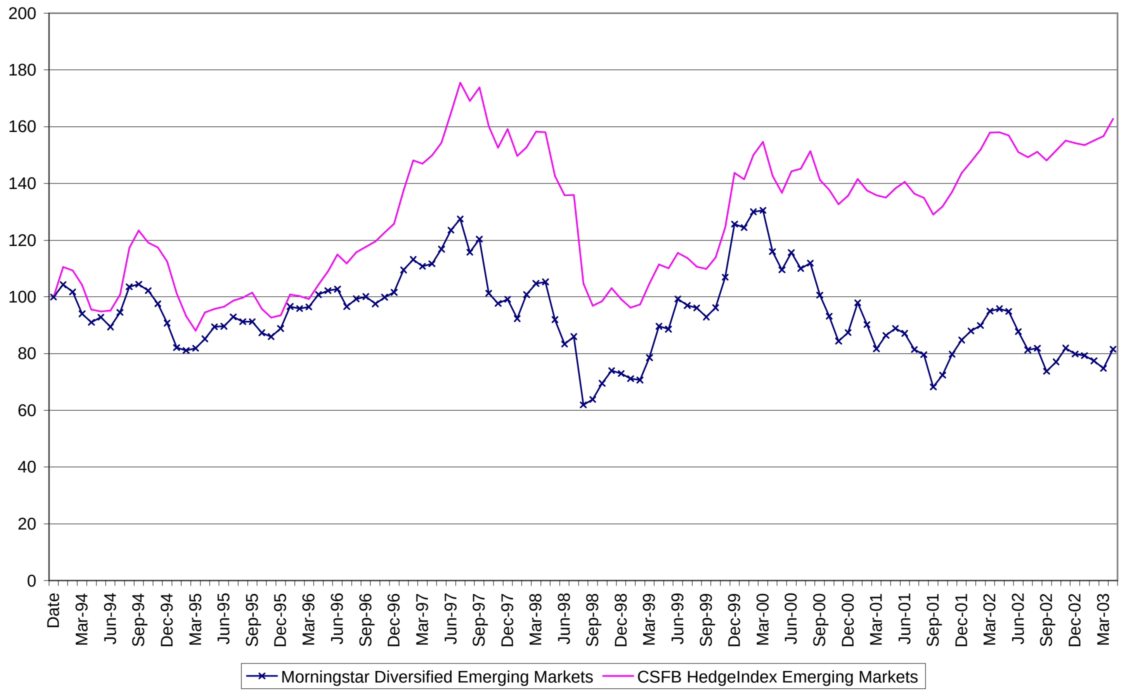
Equity Market Neutral (CSFB HedgeIndex) vs. S&P 500



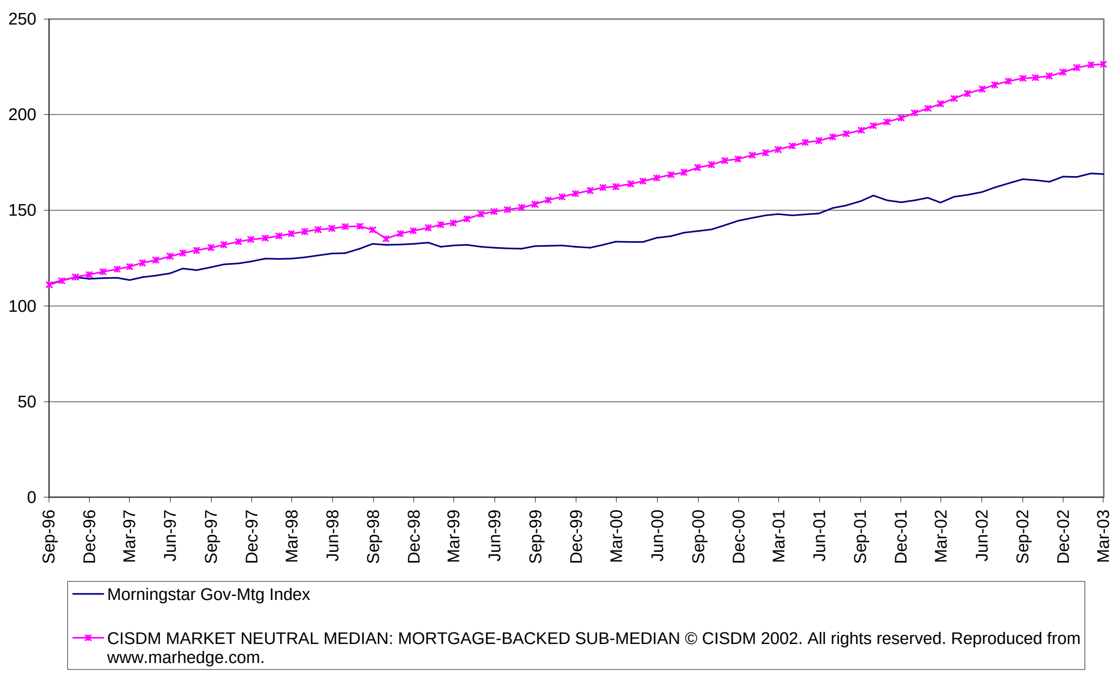
Morningstar Convertible Bonds vs. CSFB HedgeIndex Convertible Arbitrage



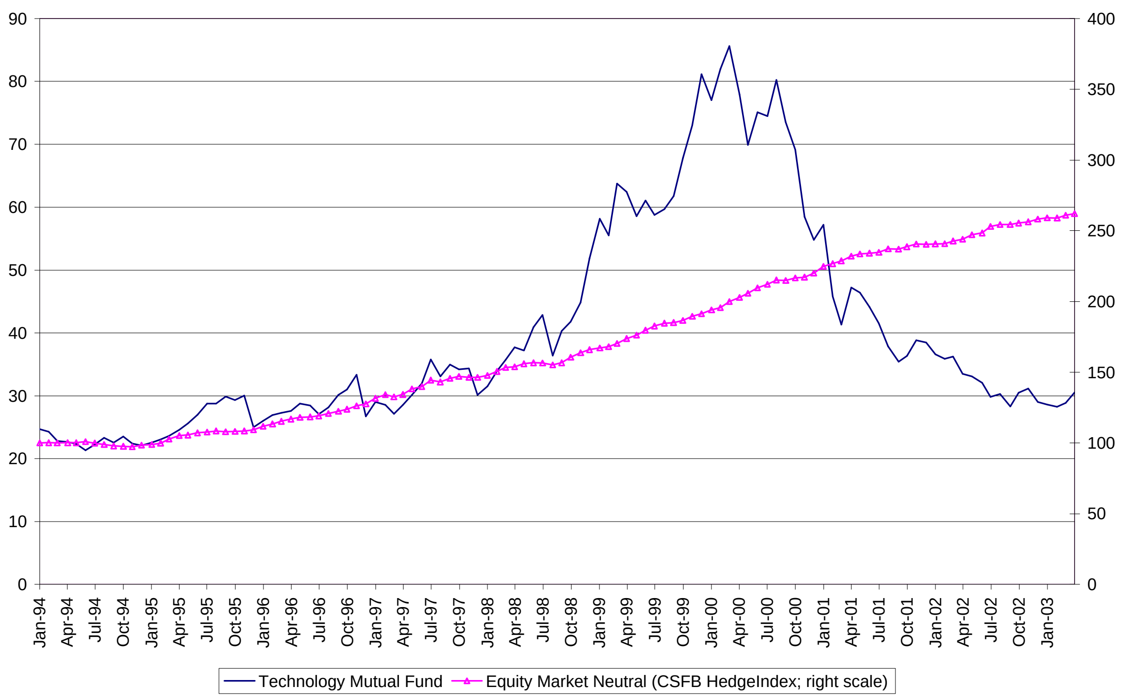
Morninstar Diversified Emerging Markets vs. CSFB HedgeIndex Emerging Markets



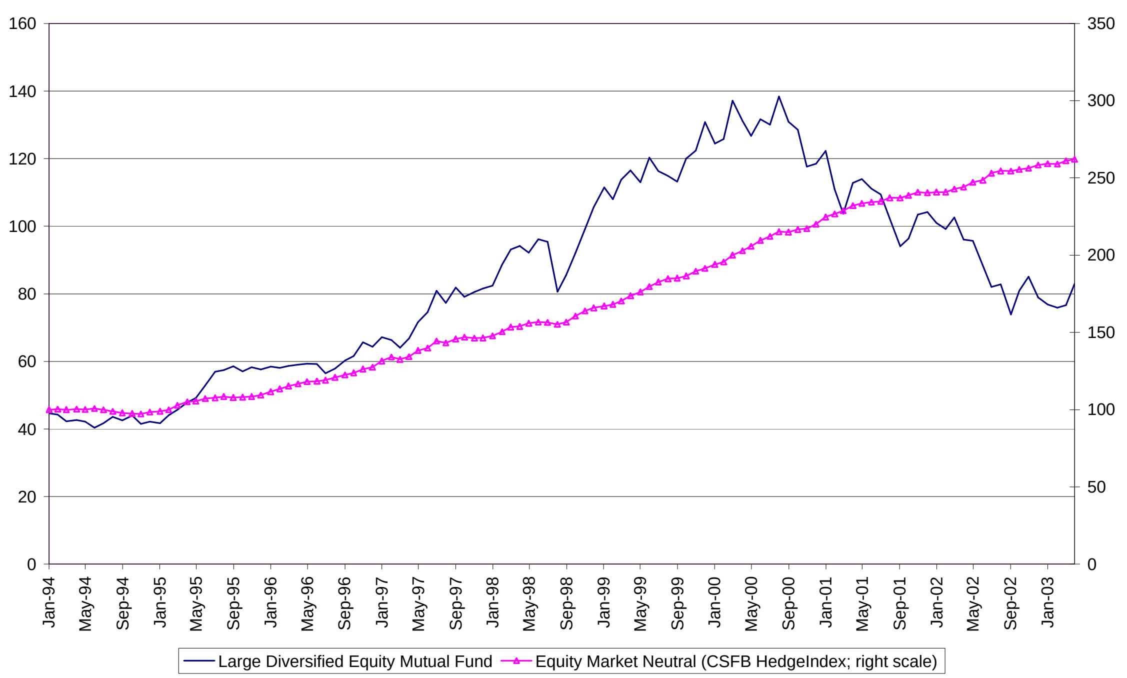
Morningstar Government Mortgage Index vs. CISDM Market Neutral Median: Mortgage-Backed Sub-Median



Equity Market Neutral (CSFB HedgeIndex) vs. Example of Technology Mutual Fund



Equity Market Neutral (CSFB HedgeIndex) vs. Example of Large Diversified Equity Mutual Fund



Appendix Two: Market Neutral Funds

Market neutral funds are a sub-set of long short equity funds. There is an additional layer of constraint that can be used in long/short and that is to make the strategy also market neutral. Market neutral tries to eliminate the fluctuations of the market and depend purely on the manager's ability to produce "alpha" (absolute returns over the index) while the long/short strategy can move from net long to net short depending upon the manager's decision. William Sharpe, the inventor of the Sharpe Ratio, had this comment to say:

> "I favor market-neutral strategies for certain kinds of active management, if the costs can be kept low, since they allow separation of asset allocation decisions from stock-picking decisions. Thus an investor can use index funds and/or derivatives to achieve a desired asset allocation, then invest in market-neutral funds to the extent that he believes some of them can add value without excessive added risk." [from Market Neutral: Engineering Return and Risk]

There are two ways to structure the market neutral strategy for equities, Beta neutral and dollar neutral.

Beta Neutral

Beta neutral is a long/short that uses complex statistical models to try and be market neutral. The manager will use a calculation of the stocks beta to determine the right ratio of long to short to achieve market neutral. The Beta of a stock is based on the historical volatility of the stock in relation to the overall market. The market has a Beta of 1 and more volatile stocks like growth stocks will have a Beta greater than 1, while less volatile stocks like value stocks will have a Beta less than 1. The stock with the beta above one in theory will go up or down more than the market and the stock with the low beta will go up or down less than the market. This one will require an illustration (assume the portfolio is valued at $10,000):

Stock A has a Beta of 1.5
Stock B has a Beta of .75
Put 33% of your portfolio in stock A ($3,333)
Put 66% of your portfolio in stock B ($6,666)

This gives a Beta of 1, which will match the market.
1.5 * .33 = .50
.75 * .66 = .50
1 = Portfolio Beta

Short stock A and go long stock B then if the overall market goes up 30%:
Stock A goes up 30% * 1.5 = 45.0% to $4,833
Stock B goes up 30% * .75 = 22.5% to $8,166

Stock A has a loss of $3,333 - $4,833 = ($1500)
Stock B has a gain of $8,166 - $6,666 = $1500

The beta neutral position has caused the portfolio to have the same loss in both positions due to the weighting based on Beta instead of weighting based equal Dollar. If the trade had been done with $5,000 allocated to both positions the portfolio Beta would be 1.125 instead of 1 and produce a ($1,125) loss if the market went up 30%. The manager makes money by correctly predicting the movement of these two stocks compared to each other, as the market risk has been hedged away.

Dollar Neutral

This is similar to the beta neutral example but the manager puts equal dollar amounts on the long and short. So the manager could be long a financial company stock like Citigroup by $100,000 and be short a financial stock like JP Morgan by $100,000. This trade will not be beta neutral if the two stocks have different betas. The other thing to realize is that depending on where the share price is trading the manager will be going short a different number of shares than he is going long. At the time of the writing JP Morgan is trading close to 30 and Citigroup is close to 40, so for dollar neutral to be achieved the manager would buy 3333 shares of Citigroup and sell short 2500 shares of JP Morgan.

Appendix 3 – Due Diligence on Hedge Funds

It's not what we know that will cause problems for our investments. It's what we don't know that always causes the disasters.

Due diligence is the process of investigating a fund or investment opportunity before you invest. It is the most important element of the investment process, and for many investors the one most ignored.

It is helpful to think of a hedge fund as a business. Investors would not invest in a business without asking a lot of questions, learning about the management and trying to decide if the potential returns were worth the risk. Essentially, all due diligence boils down to these three basic questions:

1. Is Management honest?
2. Is Management competent?
3. Does the investment strategy have the potential to do well in the future?

All three questions are critical. Let me briefly touch on the third. We have all read the sentence "Past performance is not indicative of future results." It should not be read as boilerplate language. It is the single most critical aspect of successfully investing in a fund or business.

Every fund management style will have periods of good performance. Many are very dependent upon market externals. By that, I mean if the conditions are not right, they will not make money, and may even lose a great deal. Simply investing by the numbers may not produce good results. It often – quite often - produces very poor results.

You cannot determine the above solely by reading the offering memorandum or fund marketing materials. What fund offering material says, "We are liars" or "We don't know what the hell we are doing"?

Every hedge fund, mutual fund and public stock manager will tell you "now is the best time to invest." So do most of the professional analysts.

It is important to read the offering memorandums to get a basic understanding of the fund or business structure. But that is the beginning, not the end, of the process. You will seldom get the information you need to adequately determine whether or not you should invest in a fund in offering documents, or even adequately determine the real risks to your investment.

Let's be perfectly blunt. That long offering memorandum and subscription agreement one signs is not to protect investors. The disclosure documents sent to you by mutual funds AFTER you have given them your money will not help you understand what market risks you are really taking. It is to protect the fund in case something goes wrong. Attorneys are paid large sums to think of every possible risk imaginable and then include them in the offering document, getting you to acknowledge you understand the risk. If a creative attorney thinks of some new risk or disclosure and puts it in a new offering document, that paragraph will soon start to appear in every other new document.

Offering memorandums are VERY important. Read them. Jot down questions as you do. Just remember they do not answer the most important questions.

Far more of your investment success will come from picking the right investment strategies (by this I mean broad asset classes) than by picking the right fund or stock. That being said, it would be very sad if you pick the right strategy but still fail because you do not do your homework on the fund or stock in which you invest.

It's 10 PM. Do You Know Where Your Investment Is?

"Hedge fund investors don't always understand what they're investing in. According to a study by Prince & Associates, three-fourths of the 384 affluent hedge fund investors surveyed didn't know their hedge fund's investment style or if they used leverage. And according to the study, those who didn't know, didn't want to know. But it makes for good cocktail chatter. Just pass the shrimp, please."[7]

In almost every case of hedge fund fraud, the investors simply did not do their homework. If investors went through a due diligence process like the one I describe, it is highly unlikely they will end up in a fraud. (Just to set the record straight, investor losses from hedge fund frauds are a tiny (less than 1%) fraction of the frauds just recently discovered on Wall Street.)

The far larger risk to your money is not fraud, but incompetence or poor management. Investing in hedge funds without proper due diligence is like throwing the dice. Maybe you get lucky, but more likely you will end up unhappy, at the very least.

If you go through the process, it is much more likely you will end up with a fund that is a match for your goals, and fits into your investment philosophy. You won't be having to jump from fund to fund, chasing last year's earnings. You will know what to expect, and won't get nervous when the occasional drawdown occurs. You will also have an idea of what situations – and not your emotions -- will cause you to exit the fund.

Finding a good hedge fund is not easy. There is no Morningstar of hedge funds like there is for mutual funds. It is not that there are not a lot of hedge funds, but that there is no central source for listing funds. Industry sources tell us there are at least 6,000 hedge funds and private pools by the latest estimates, and some knowledgeable industry analysts now put that number closer to 7,000. My guess is that less than a third are in the public databases. (A third of the hedge funds in my fund of funds do not list themselves in the public databases.)

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[7] Rich Peebles from www.prudentbear.com
http://www.prudentbear.com/archive_comm_article.asp?category=Market+Summary&content_idx=12111

I recently saw a study which analyzed two public hedge fund databases of over funds, but there was only 30% overlap between the two databases. There was only a combined 2,000 unique funds in both databases. This all goes to say that finding a good fund is hard work.

There are a variety of styles among hedge funds. Finding the style that is right for your investment needs is critical. Some hedge funds managers are good and some are just lucky. You do NOT want to invest in the lucky one, as luck always runs out, typically just after you invest. There are any numbers of ways that managers can hide problems in their management styles. It is important to uncover them before you invest. Hedge funds are businesses. The business side of the fund is just as important as the investment side. Are the managers good businessmen as well as smart investors?

The Due Diligence Process

Institutional investors, family offices and hedge fund analysts like myself usually have a lengthy list of questions we ask to prospective hedge funds. These questions are designed to give us the information we need to evaluate the fund. Further, they help us decide between funds which are similar in style and performance. There are hundreds of market neutral and long-short equity hedge funds. Choosing between one or another can be difficult.

As an example, I might want a 15-20% exposure to convertible arbitrage in my fund. There are scores of such funds, and a number of them may make it through the initial screening rounds. On the surface, the funds may look alike. They may even have similar trading styles. What would make me choose one fund over another? Which fund has the best “edge”? In many cases, it comes down to comfort levels. How much confidence do I have that my money (and that of my clients!) is being managed well and is safe?

In the process of writing this essay, I sent an email to a number of my friends in the hedge fund community, and asked them to send me their due diligence questionnaires. I also asked a number of hedge funds to send me some of the questionnaires they get which they thought were particularly good. As you might suspect, the majority of the questions were similar. But what was interesting to me were the differences.

Most of the forms had one or two sets of questions designed to ferret out a particular set of issues or problems. My deep suspicion is that these differences were brought about by the authors having experienced an unpleasant relationship, and the questions were designed to avoid that problem in the future. I must confess that my own forms were not an exception to this rule.

I began to compile and organize the questions into one due diligence document. I was amazed at the length of the document as I finished. I decided I must cut the number of questions down, as they numbered over 100, and many were multi-part.

The problem was, however, that as I reviewed the document over a few weeks, each piece of information was important, and gave further insight into the company or comfort about the safety of your money. There was not one question I wanted to delete, and again I must confess I added a few more questions as I thought through the process.

The questions are designed to give us insight into the fund on several different levels. The most important thing to understand about a fund is “Why” it makes money. If you cannot understand the “Why” of a fund, you should not be investing. This is the critical question that will help you understand what the dominant factor in performance of the fund is: skill or luck. As I stated earlier, luck always runs out, typically just after you invest. More funds are based upon luck or random chance than you might think, but I can guarantee you no fund manager will admit it, and most of them would be insulted if you said so. Genius is a rising market, and good performance has persuaded more than one manager they are geniuses. Avoiding such genius is crucial to capital preservation. Finding true investment ability (genius or not) is the secret to capital growth.

The next most important question is “How” the fund makes money. What are the strategies and systems used, and what is the risk taken?

If you can get a good feeling about those two questions, then you follow up with the more mundane but critical questions of “Who”, operational issues, structure, safety of assets and, of course, performance.

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For those who would like a more detailed analysis of how to do due diligence on hedge funds and investments in general, I have posted a list of the due diligence questions along with my commentary on them. Interested parties can find this document at http://www.absolutereturns.net/chapters.htm .

John Mauldin

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Millennium Wave Investments is a state registered investment advisor and is registered with the CFT as a Commodity Pool Operator/ Commodity Trading Advisor. Mauldin is a registered representative of Williams Financial Group.

John is a prolific author, writer and editor of the popular Thoughts from the Frontline newsletter which goes to almost 2,000,000 readers weekly, and is posted on numerous independent websites. He is also a frequent contributor to other financial publications, including the Fleet Street Letter. His new book, "Absolute Returns", due out in Q3 of 2003, will pull back the curtain on the world of private offerings for individual investors. (To view some chapters today, go to (www.absolutereturns.net).

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John demonstrates an unusual breadth of expertise, as illustrated by the wide variety of issues addressed in-depth in his writings. He has a unique ability to present complex financial topics and make them understandable to the lay reader. His background includes a wide variety of studies and experiences and he has traveled extensively. John speaks at numerous investment conferences and seminars. These range from small gatherings focused on high net worth individuals to large conferences geared to average investors.

John is a Fort Worth, Texas businessman, married to his wife Eunice (she is John's favorite Canadian import) and the father of seven children, ranging in age from 8 through 25, five of whom are adopted. He graduated from Rice University in 1972, with a Bachelor of Arts degree and from Southwestern Baptist Theological Seminary with a Master of Divinity in 1974. From 1982 to 1987, he was Chief Executive Officer of the American Bureau of Economic Research, Inc., a publisher of newsletters and books on various investment topics, from 1982 to 1987. From 1989 until 2000, he was a partner in ProFutures Investments. He sold his interests in ProFutures to start Millennium Wave Investments in 2000. He was one of the founders of Adopting Children Together, Inc., which was at that time the largest adoption support group in Texas. He currently serves on the board of directors of The International Reconciliation Coalition and the International Children's Relief Fund. He is also a member of the Knights of Malta, and has served on the Executive Committee of the Republican Party of Texas.

When considering alternative investments, including hedge funds, you should consider various risks including the fact that some products: often engage in leveraging and other speculative investment practices that may increase the risk of investment loss, can be illiquid, are not required to provide periodic pricing or valuation information to investors, may involve complex tax structures and delays in distributing important tax information, are not subject to the same regulatory requirements as mutual funds, often charge high fees, and in many cases the underlying investments are not transparent and are known only to the investment manager. And always, without fail, remember that past performance is not indicative of future results.